1990

Life and health insurance industry developments - 1990; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK
ALERTS

Life and Health Insurance Industry Developments—1990

Update to AICPA Industry Audit Guide
Audits of Stock Life Insurance Companies

Includes *Audit Risk Alert—1990*

Issued by the
Auditing Standards Division

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This document, which contains *Life and Health Insurance Industry Developments—1990* and *Audit Risk Alert—1990*, is intended to provide auditors of financial statements of life and health insurance companies with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

Gerard L. Yarnall
Director, Audit and Accounting Guides

Ellise G. Konigsberg
Technical Manager, Accounting Standards Division

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Life and Health Insurance Industry Developments—1990

Industry and Economic Developments

The profitability of products of life insurance companies continues to be a critical concern. Life insurance insolvencies have increased significantly since 1987. Competition in product pricing, design, and interest crediting rates has led to more active and aggressive investment strategies, more active and aggressive cost control efforts, and an increased focus on "interest spread management." The lower profitability of life insurance and annuity products has reduced the surplus levels of some companies. In general, the life insurance industry continues to face fundamental changes in its structure and in the ways that companies design, market, and distribute their products. The industry is confronted with increased competition from banks and others in the marketing and distribution of insurance-related products and services, and the industry is challenged by the trend toward globalization of financial services industries and consolidation within the industry.

Historically, the group health insurance industry has operated in a cyclical economic environment. Although premium rates have increased significantly in recent years, the continuing spiral in health care costs can be expected to lead to further changes in health care delivery systems and in the financing of health care services.

The insurance industry also faces significant challenges from increases or changes in the regulation of its operations, including (among other matters) new tax developments, changes in federal health insurance programs, and increased scrutiny of the industry by both regulatory authorities and Congress. The life and health insurance industry has experienced increased regulatory attention as a result of concerns about the quality of insurance company investments in junk bonds, real estate, and mortgage loans. The Securities and Exchange Commission (SEC) also continues to focus attention on the industry's accounting and reporting issues. Finally, the industry faces an increased tax burden under the Revenue Reconciliation Act of 1990 (the "1990 Tax Act").

Overall Risk Factors

Although circumstances vary from company to company, the following are some of the conditions specific to the life and health insurance industry that affect the industry's overall audit risk:

- The historically cyclical underwriting patterns of health insurance and rapid increases in health care costs
- Widespread competition in product pricing and interest crediting rates
- Narrow profit margins and high administrative costs, particularly for interest-sensitive products
- The potential impact of acquired immune deficiency syndrome (AIDS) on underwriting practices, product pricing, claims, and benefit reserves
- Evolving changes in the regulatory oversight and reporting requirements of the industry, which affect most of the industry's functions
- Credit risk and liquidity risk associated with such investments as junk bonds, real estate, mortgage loans, and investments with affiliates
- The need for appropriate maturity matching of assets and liabilities to allow for the payment of benefits when due or demanded by policyholders
- The need to meet capital and surplus requirements imposed by regulatory authorities, and the need for sufficient capital and surplus to support company growth and stability
- The 1990 Tax Act and its impact on the current taxes, tax expense, and net income of life insurance companies

Investments

The turmoil in the junk bond markets and the rapid softening of commercial real estate markets in various regions of the country have raised concerns about the quality of insurance companies' investment portfolios. In addition, large investments in affiliates may indicate a higher degree of audit risk. Among the types of investments that may require increased audit attention in 1990 are the following:

- High-yield, high-risk junk bonds
- Private placements

- Mortgage and real estate loans
- Real estate
- Joint ventures and partnerships
- Investments in affiliates

The risks associated with investments may involve credit risk (that is, the risk that a party may default on its obligations), market risk (the risk that values may be adversely affected by changes in interest rates or other price changes), liquidity risk (an inability to readily sell investments to generate cash to pay obligations), and off-balance-sheet risk (the potential for losses in excess of amounts recorded in the financial statements, such as potential losses that may be associated with guarantees or commitments).

Debt Securities

The turmoil in the junk bond markets, which began in 1989, continued into 1990. A principal concern has been the credit risk inherent in such higher-risk investments. The current recessionary economic environment may add to the concerns that issuers of such debt securities may default. In addition, the lack of a highly organized market and the relative lack of buyers for such securities have raised concerns about the liquidity of investments in junk bonds.

Investments in private placement debt securities may involve risks that are similar to those investments in junk bonds. In particular, the lack of a ready market for privately issued debt may cause concerns over the liquidity of investments in private placement debt securities and may make it difficult to determine the market value of such investments.

Investors in mortgage-backed securities may face increased market risk in an unsettled economic environment because the market values of such investments fluctuate with the levels of mortgage prepayments and refinancings. In addition, mortgage-backed securities that are not guaranteed by a financially stable guarantor may present a credit risk to the investor.

Auditors should consider whether declines in the market value of debt securities are other than temporary. An auditing interpretation of Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards,* vol. 1, AU sec. 9332.01–.14), discusses factors that auditors should consider in evaluating the reasons for market declines when market value is below cost, as well as the types of evidential matter that auditors should obtain in evaluating whether management has properly classified marketable securities as current or noncurrent assets and whether amounts at which they are carried in the financial statements are appropriate.

Debt Securities Held as Assets. An exposure draft of a proposed statement of position (SOP), *Reporting by Financial Institutions of Debt Securities Held as Assets*, was issued for comment in May 1990 to provide guidance on applying GAAP in reporting debt securities held as assets by financial institutions, including insurance companies. In September 1990 the AICPA Accounting Standards Executive Committee (AcSEC) agreed to issue an SOP recommending expanded disclosures and to study the further recognition and measurement issues.

The "disclosure" SOP, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*, is effective for financial statements for fiscal years ending after December 15,1990. SOP 90–11 requires financial institutions to include an explanation of accounting policies for debt securities held, including the basis for classification into balance-sheet captions, such as investment or trading, in the notes to the financial statements. In addition, financial institutions must disclose the following in the notes to the financial statements for debt securities carried at either historical cost or the lower of cost or market:

- For each balance sheet presented, the amortized cost, estimated market values, gross unrealized gains, and gross unrealized losses on pertinent categories of securities
- For the most recent balance sheet, the amortized cost and estimated market values of debt securities due:

  —In one year or less

  —After one year through five years

  —After five years through ten years

  —After ten years
- For each period for which results of operations are presented, the proceeds from sales of such debt securities and gross realized gains and gross realized losses on such sales

With respect to the recognition and measurement issues, AcSEC sent a letter to the Financial Accounting Standards Board (FASB) on October 31, 1990, recommending that the FASB add a limited-scope project to its agenda on recognition and measurement of debt securities held as assets by financial institutions. On November 14,1990, the FASB agreed to consider accelerating a portion of its financial instruments project to address this issue. However, the scope of such a project has not yet been defined.

In addition to the above, the SEC staff indicated, in a December 1989 letter, that it will continue the current practice of reviewing the adequacy of disclosures made by SEC registrants in this area. The SEC staff believes the following disclosures are appropriate for SEC registrants:

- The accounting policy note to the financial statements should clearly identify the characteristics that must be present for the institution to carry a security at amortized cost, rather than at market or lower of cost or market.
- The market value of the portfolio should be disclosed on the face of the balance sheet. If the portfolio is underwater, management's discussion and analysis (MD&A) should assess the significance of the unrealized loss relative to net worth and regulatory capital requirements.
- Proceeds from the sales of securities should be distinguished from the proceeds of maturities in the statement of cash flows or in a note thereto.
- Gross unrealized gains and gross unrealized losses in the portfolio should be disclosed separately in the MD&A. Disclosure in the notes to the financial statements is recommended.
- Gross realized gains and gross realized losses should be separately disclosed in the MD&A. Disclosure in the notes to the financial statements is recommended.
- MD&A should analyze and, to the extent practicable, quantify the likely effects on current and future earnings and investment yields and on the liquidity and capital resources of material unrealized losses in the portfolio, material sales of securities at gains, and material shifts in average maturity. A similar analysis should be provided if a material portion of fixed-rate mortgages maturing beyond one year carries rates below current market.
- If sales out of the portfolio were significant, the MD&A should describe these events unforeseen at earlier balance-sheet dates that caused management to change its investment intent. Restatement of earlier reports may be necessary if material sales occurred at a loss and the ability and intent to hold at earlier dates cannot be demonstrated.
- If a material proportion of the portfolio consists of securities that are not actively traded in a liquid market, MD&A should disclose that proportion, describe the nature of the securities and the source of market value information, and discuss any material risks associated with the investment relative to earnings and liquidity. Similar disclosure should be furnished if the portfolio includes instruments whose market values are highly volatile relative to small changes in interest rates and if this volatility may materially affect operating results or liquidity.

- Investments held for sale, categorized by types of investments, should be presented separately from the balance of the investment portfolio in Table II, "Investment Portfolio," of Industry Guide 3 data. Contractual maturities of investments held for sale need not be presented.

The SEC staff stated that it will be reviewing statements of cash flows of registrants to detect companies in the financial services industries (including insurance companies) with significant sales activities in their investment portfolios. The SEC also has requested that companies separately disclose the proceeds from sales of bonds and maturities of bonds in their statements of cash flows. The SEC staff expects that the MD&A sections of registrants' reports will discuss the reasons for trading activity in an investment portfolio and that discussions of realized gains in the portfolio should be accompanied by discussions of potential unrealized losses remaining in the portfolio.

The National Association of Insurance Commissioners (NAIC) has adopted a variety of new rules affecting insurance company investments in high-yield bonds. For life and health insurance companies, the new rules specify six, rather than the previous four, categories of bonds based on investment quality. The new rules also require a series of increases in the mandatory securities valuation reserves (MSVR) of life and health insurance companies for investments in bonds in the lower-rated categories. The new rules also provide for certain changes in the procedures of the NAIC's Securities Valuation Office (SVO) for evaluating and classifying bonds and certain changes in the annual statement for reporting the quality of investments in bonds.

The changes first become effective for 1990 annual statements. However, the changes regarding the MSVR calculation will be phased in over the period from 1990 through 1995.

Mortgage Loans and Real Estate

In 1990, real estate markets underwent rapid changes, and deterioration in real estate markets spread to additional regions of the United States. The rates of default and nonperforming loans on commercial mortgages increased significantly, and falling market prices for commercial real estate raised the need for a review of investment portfolios and the appropriateness of related accounting policies. Among the factors that may require additional audit attention are the following:

- Restructurings or refinancings of loans and the related accounting treatment
- Concentrations of loans in particular borrowers, types of properties, or geographical regions that are experiencing economic

difficulty or may be reasonably expected to experience such problems in the future

- Valuation practices for property acquired in foreclosure, including the company's policies for obtaining appraisals of such properties
- The consistency and reasonableness of the company's policies for determining nonaccrual of interest on loans whose interest or principal payments are past due
- The company's policies for determining (1) allowances for losses and valuation allowances on mortgage loans and investment real estate and (2) changes in such allowances in the past year

The SEC staff indicated, in a letter to insurance company registrants, that it will be reviewing the adequacy of discussion and disclosure in reports regarding material holdings of mortgage loans and investment real estate. In addition to appropriate financial statement disclosures, the SEC staff is expected to focus on the adequacy of discussion in the MD&A sections in registrants' reports regarding the risks and the related impact of such holdings on financial condition, results of operations, and liquidity.

Joint Ventures and Partnerships

Insurance companies may invest indirectly in real estate or other high-risk investments through participation in joint ventures or partnerships. Losses by joint ventures or partnerships may necessitate additional contributions by investors. In addition to evaluating the reasonableness of the valuation of such investments in joint ventures or partnerships, auditors should make inquiries concerning the existence of obligations or commitments for additional funding or guarantees of obligations of the investee that may require recognition or disclosure in the financial statements.

Investments in Affiliates

Investments in affiliates, in the form of equity investments or loans to affiliates, may present a higher liquidity risk for insurance companies or holding companies. Often, a parent holding company's major asset is its investment in insurance subsidiaries. Consideration should be given to the statutory restrictions on the ability of insurance company subsidiaries to pay dividends or transfer funds to a parent company, because such restrictions may affect the liquidity of the parent company and may affect the recoverability of amounts due from the parent company.

Other Investment Transactions

Auditors should inquire whether significant or unusual investment transactions exist and evaluate the appropriateness of the accounting treatment. The types of investment transactions that may be considered include dividend capture or dividend rolls, delayed delivery sales, covered call options, asset transfers with a put option, stocks owned with a call option, wash sales, investment swaps, and sale and leaseback transactions. Particular attention should be given to transfers of assets to or from affiliates or special-purpose entities.

Auditors should take particular care in evaluating transactions (1) that result in a material adjustment of statutory income or surplus or (2) for which the effect on the statutory-basis financial statements is substantially different from the effect on statements prepared in conformity with generally accepted accounting principles (GAAP), especially when a company's surplus is at or near statutory minimum levels. Among the items that may be considered in evaluating such transactions or related adjustments to the statutory surplus are the company's correspondence with state insurance departments and the documentation of compliance with applicable insurance laws or regulations.

FASB Statement No. 97 Accounting Issues

FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* requires that insurers periodically evaluate the continuing reasonableness of their estimates of future gross profits that are the basis for amortizing deferred policy acquisition costs for universal life-type policies and certain investment contracts. When experience or other factors indicate that gross profit estimates are no longer appropriate, the gross profit assumptions are to be "unlocked" and the unamortized balance of deferred policy acquisition costs is to be recalculated from the inception of the policies using the revised estimates of gross profits. The effect of the change in amortization is to be included in income of the period in which the unlocking occurs.

FASB Statement No. 97 states that the continuing reasonableness of estimates of gross profits should be "evaluated regularly." The effort required of companies to develop gross profit estimates and to support changes in those estimates will often be considerable. Delaying the unlocking process will tend to increase the income statement effect in the period in which a company finally unlocks. Accordingly, companies should be encouraged to establish procedures to monitor actual and expected gross profits and to establish a consistent policy regarding unlocking. Some companies' information systems may need significant improvements to provide the information needed to monitor actual and expected gross profits in a meaningful and timely fashion.

In December 1990 the AICPA issued Practice Bulletin No. 8, *Application of FASB Statement No. 97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments," to Insurance Enterprises*. Practice Bulletin No. 8 provides guidance, in the form of questions and answers, on a number of specific issues regarding the application of FASB Statement No. 97. Practice Bulletin No. 8 provides practitioners with guidance on enhancing the quality and comparability of financial statements.

Accident and Health Insurance

The group accident and health insurance market is currently experiencing favorable underwriting results due to the substantial premium increases instituted in the last two years. Medical claims costs are still increasing at high rates; however, there is evidence that the cycle is beginning to turn downward as price competition among health insurers increases. This change in the underwriting cycle may prevent some carriers from rebuilding their surpluses to desired levels.

Auditors should inquire as to (1) companies' approaches for considering the effect of the continuing high rate of inflation in medical care costs in evaluating the reasonableness of reported reserves for health insurance and (2) the adequacy of premium rates in evaluating potential loss-recognition situations.

Reinsurance

Insurance regulators continue to take a restrictive position against "surplus relief" reinsurance contracts (that is, contracts that do not, in substance, transfer risk). If, acknowledging challenges to the assumption that a contract transfers risk, a regulator were to conclude that the substance of a contract is, in effect, surplus relief, the reinsurance credit in the statutory-basis financial statements could be disallowed and the company's statutory surplus decreased accordingly. Thus, if it is possible that a regulator may disallow a reinsurance credit, consideration should be given to whether the ceding company's statutory surplus would be so impaired as to limit its ability to write new business or meet minimum surplus requirements. In those cases, the circumstances should be adequately disclosed, including, for public companies, appropriate commentary in the MD&A sections of reports. For GAAP purposes, such treaties would be accounted for as financing arrangements.

Changes in Federal Income Taxation of Life Insurance Companies

The Revenue Reconciliation Act of 1990 (the "1990 Tax Act"), enacted in November 1990, contains provisions that will increase the tax burden of the life insurance industry. A major provision of the 1990 Tax Act is a requirement that insurance companies capitalize and amortize a portion of their policy-acquisition costs based on specified percentages of net premiums deemed to be received on or after September 30, 1990. The capitalized amounts will generally be amortized over a ten-year period. This requirement to defer deductions for policy-acquisition costs applies to group life insurance, annuity contracts, other life insurance contracts, and accident and health insurance contracts (both noncancelable and guaranteed renewable).

The following are other provisions of the 1990 Tax Act specifically affecting life insurance companies:

- The treatment of deferred acquisition costs for alternative minimum tax purposes has been repealed. For tax years that include September 30, 1990, a transitional rule applies the repeal on a pro rata basis. For companies that qualify as "small insurance companies," the repeal is effective for tax years beginning after December 31, 1989.
- Life insurers will be allowed to deduct only 80 percent of unearned premium reserves and advance premiums relating to cancelable accident and health insurance for tax years beginning on or after September 30, 1990.
- The required capitalization and amortization of ceding commissions on indemnity and assumption reinsurance transactions has been repealed for most ceding commissions incurred on or after September 30, 1990.

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Copies of AICPA authoritative guidance may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or (800) 248-0445 (NY). Copies of FASB authoritative guidance may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

Audit Risk Alert—1990*

General Update on Economic, Industry, Regulatory, and Accounting and Auditing Matters

Introduction

This alert is intended to help auditors in finalizing their planning for 1990 year-end audits. Successful audits are a result of a number of factors, including acceptance of clients with integrity, adequate partner involvement in planning and performing audits, an appropriate level of professional skepticism, and the allocation of sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

It is important to make sure that written audit programs are *adequately tailored* to reflect *each client's circumstances*, including areas of greater *audit risk*. This alert identifies areas that, based on current information and trends, may be relevant to many 1990 year-end audits. Although it does not provide a complete list of risk factors to be considered, and the items discussed do not affect risk in every audit, this alert can be used as a planning tool for considering matters that may be especially significant for 1990 audits.

Economic Developments

The Current Economic Downturn

Dramatic events in the Persian Gulf and around the world have raised many questions and concerns for American companies. Rising oil prices, lower consumer demand, and reduced availability of capital are just *some* of the factors affecting companies in all industries. Auditors should take these economic factors into consideration and be aware of the ways in which clients have been affected by them as well as of the potential, if any, of a going-concern problem.

*This Audit Risk Alert was published in the December 1990 issue of the AICPA's *CPA Letter.*

Business Failures on the Rise

The current illiquidity in the junk-bond market, coupled with the continuing tightening of credit by lenders throughout the country, have made it substantially more difficult for prospective borrowers to obtain financing, particularly for highly leveraged companies. A recent article in the *Wall Street Journal* called attention to increases in bankruptcy filings, particularly in the real estate, apparel, retailing, and construction industries, due in large part to the weakening cash flow of many businesses as well as the more cautious credit environment. Some industries are becoming very risky undertakings. For example, in 1990, the number of restaurant closings exceeded the number of openings; increased competition has made it nearly impossible to raise menu prices, while costs have continued to increase, especially those for energy, insurance, and wages.

The effects of the economic slowdown will vary across geographic regions and industries, and among companies even within the same industry. Therefore, auditors need to focus specifically on the environment of each client and address each client's particular issues accordingly. Nevertheless, many companies will be unable to pass on increased costs (particularly increased oil prices and medical expenses) due, in part, to increasing competition and softening demand for their products. This could make it difficult for companies to report favorable operating results for the year. With this in mind, auditors should be even more sensitive this year to ongoing issues that affect operating results, such as the collectibility of receivables and the potential obsolescence and realizability of inventories.

Highly leveraged companies are particularly vulnerable to a downturn in business activity and the other factors discussed above. Auditors should consider these circumstances when evaluating the ability of highly leveraged clients to continue as going concerns.

Economic Considerations Relating to Debt

Adverse developments in the economy in general, or in a particular financial institution, may cause an institution to refuse to renew loans, to exercise demand clauses (such as the due-on-demand clause), or to decline to waive covenant violations. In addition, these developments may make it more difficult for companies to obtain alternate sources of financing than in the past. In these cases, the auditor should consider the borrower's classification of the liability, potential going-concern issues, management's plans (such as those for alternate financing or asset disposition), and the adequacy of disclosures in the borrower's financial statements. Securities and Exchange Commission (SEC) rules contain specific disclosure requirements in Management's Discussion and Analysis (MD & A) about liquidity and material uncertainties.

Regulatory and Legislative Developments

Environmental Liabilities

The Environmental Protection Agency is empowered by law (through the Superfund legislation) to seek recovery from anyone who ever owned or operated a particular contaminated site, or anyone who ever generated or transported hazardous materials to a site (these parties are commonly referred to as potentially responsible parties, or PRPs). Potentially, the liability can extend to subsequent owners or to the parent company of a PRP.

In connection with audit planning, the auditor should consider making inquiries of management about whether a client (or any of its subsidiaries) has been designated as a PRP or otherwise has a high risk of exposure to environmental liabilities. If a client has been designated as a PRP, the auditor should consider whether any amount should be accrued for cleanup costs and assess the need for disclosure and, possibly, for the inclusion of an explanatory fourth paragraph in the audit report citing the uncertainty, if management is unable to make reasonable estimates of the costs. In addition, for public entities, disclosure should be made in MD&A of estimates of cleanup costs or the reasons why the matter will not have a material effect.

Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies,* and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* provide guidance for the accounting and disclosure of loss contingencies, including those related to environmental issues. The FASB's Emerging Issues Task Force (EITF) reached a consensus in Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination,* that, generally, the costs incurred to treat environmental contamination should be expensed and may be capitalized only if specific criteria are met.

Notification of Termination of Auditor-Client Relationship

The SEC staff has observed instances in which CPA firms have not notified the SEC's Chief Accountant when an auditor-client relationship ends. Under a rule effective May 1, 1989, member firms of the SEC Practice Section of the AICPA Division for Firms must notify the SEC directly by letter *within five business days* after the auditor resigns, declines to stand for reelection, or is dismissed.

New Auditing Pronouncements

Implementing SAS No. 55 on Internal Control

AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* is effective for audit periods beginning on or after January 1, 1990. Auditors who did not apply its provisions early are faced with implementation for December 31, 1990, year-end audits.

To help auditors with questions that may arise, the Auditing Standards Board (ASB) issued the Audit Guide *Consideration of the Internal Control Structure in a Financial Statement Audit.* The guide presents two preliminary audit strategies for assessing control risk and uses three hypothetical companies ranging from a small, owner-managed business to a large public company to illustrate how the strategies affect the nature, timing, and extent of procedures. Particularly helpful is a series of exhibits that includes sample workpapers documenting the hypothetical companies' compliance with SAS No. 55. A copy of the guide (product number 012450) may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or at (800) 248-0445 (NY).

New Financial Institutions Confirmation Form

The AICPA will replace the existing 1966 Standard Bank Confirmation Inquiry. The new form will provide only confirmation of *deposit* and *loan* balances. To confirm other transactions and arrangements, auditors will have to send a separate letter, signed by the client, to a financial institution official responsible for the financial institution's relationship with the client or knowledgeable about the transactions or arrangements. Anyone ordering the new standard form from the AICPA Order Department will receive a copy of a notice to practitioners, which describes the revisions to the process of confirming information with financial institutions, and illustrative letters for confirming some of these types of transactions or arrangements. The new form should be used for confirmations mailed on or after March 31, 1991. Practitioners should neither use the new form before March 31, 1991, nor use the old form on or after that date.

New SAS on Internal Auditing

In January 1991, the ASB will issue a new SAS, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* that will provide practitioners with expanded guidance when considering the work of internal auditors. Many internal audit activities are relevant to an audit of financial statements because they provide evidence about the design and effectiveness of internal control structure policies and procedures or provide direct evidence about misstatements of financial data contained in financial statements. The SAS is effective for audits of financial statements for periods beginning on or after January 1, 1991, and will include guidance to assist auditors in obtaining an understanding of the internal audit function, assessing the competence and objectivity of internal auditors, and determining the extent to which they may consider work performed by internal auditors. The SAS supersedes SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit*, and incorporates the terminology and concepts of more recent SASs, particularly SAS No. 55.

Forthcoming Guidance on Circular A-133

On March 8, 1990, the Office of Management and Budget (OMB) issued Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. The purpose of Circular A-133 is to establish audit requirements and to define federal responsibilities for implementing and monitoring audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards. Institutions covered by Circular A-133 generally include colleges and universities (and their affiliated hospitals) and other not-for-profit organizations, such as voluntary health and welfare organizations and other civic organizations.

The circular applies to nonprofit institutions that receive $100,000 or more in federal awards. (Circular A-133's definition of *financial awards* is broader than the term *financial assistance* used in SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*.) Nonprofit institutions that receive at least $25,000 but less than $100,000 in federal financial assistance have the option of applying either the requirements of Circular A-133 or separate program audit requirements. For institutions receiving less than $25,000, records must be kept and made available for review, if requested, but the provisions of the circular do not apply.

In the first quarter of 1991, the AICPA's Auditing Standards Division plans to expose a statement of position, prepared by a subcommittee of the AICPA Not-for-Profit Organizations Committee, that will provide guidance about compliance-auditing requirements in Circular A-133. Circular A-133 is effective for audits of fiscal years beginning on or after January 1, 1990. Since the circular permits biennial audits, some institutions may not be required to follow its requirements until the audit of their financial statements for the fiscal year ending June 30, 1992.

Audit Reporting and Communication Issues

Reporting on Uncertainties

Some auditors have issued an unqualified report with an additional paragraph about the existence of an uncertainty in situations when a qualified or adverse opinion should have been issued.

SAS No. 58, *Reports on Audited Financial Statements,* requires an auditor to add an explanatory paragraph (after the opinion paragraph) to the standard report when a matter is expected to be resolved at some future date, at which time sufficient evidence about its outcome is likely to be available. Examples of such uncertainties include lawsuits against the entity and tax claims by tax authorities when precedents are not clear. Because its resolution is prospective, sometimes management cannot estimate the effect of the uncertainty on the entity's financial statements. However, those uncertainties have, in some cases, been confused with other situations in which management asserts that it is unable to estimate certain financial statement elements, accounts, or items.

Generally, matters whose outcomes depend on the actions of management and relate to typical business operations are susceptible to reasonable estimation and, therefore, are estimates inherent in the accounting process, not uncertainties. Management's inability to estimate in these situations should raise concerns about the possible use of inappropriate accounting principles or scope limitations. If the auditor believes that financial statements are materially misstated because of the use of inappropriate accounting principles, a qualified or adverse opinion is required due to the GAAP departure. A scope limitation should result in a qualified opinion or a disclaimer of opinion.

Going-Concern Matters

When an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern, SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* requires the auditor to include an explanatory paragraph (following the opinion paragraph) in the report to reflect that conclusion. Auditors have issued reports in which it is unclear whether they are expressing a conclusion that there is substantial doubt about an entity's ability to continue as a going concern.

For situations in which the auditor expresses such a conclusion, the ASB recently amended SAS No. 59 to require the use of the phrase "substantial doubt about the entity's ability to continue as a going concern" (or similar wording that includes the terms *substantial doubt* and *going concern*) in the required explanatory paragraph.

Required Communications to Audit Committees and Others Having Oversight Responsibility

Instances have been noted in which auditors have overlooked the communication requirements of SAS No. 61, *Communication With Audit Committees*. This statement requires auditors to ensure that certain matters are communicated to audit committees or other groups with responsibility for oversight of the financial reporting process. SAS No. 61 applies to—

- Entities that have an audit committee or a formally designated group having oversight responsibility for financial reporting (for example, a finance or budget committee).
- All SEC engagements as defined in note 1 of the statement.

In considering the communications required by SAS No. 61, the auditor should also not overlook the communications required by the following:

- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
- SAS No. 54, *Illegal Acts by Clients* (see discussion below)
- SAS No. 60, *Communications of Internal Control Structure Related Matters Noted in an Audit*

Illegal Acts

SAS No. 54 provides guidance for communications with clients of possible illegal acts. The auditor has a responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on financial statement line-item amounts. Auditors may also become aware of other illegal acts that have, or are likely to have, occurred and that may not have a direct and material effect on financial statement amounts.

Auditors should assure themselves that all illegal acts that have come to their attention, unless clearly inconsequential, have been communicated to the audit committee or its equivalent (the board of trustees or an owner-manager) in accordance with SAS No. 54.

Recurring Audit Problems

Questionable Accounting Practices

Managements of companies—public or private—might feel pressure to report favorable results—for example, to maintain a trend of growth in earnings, support or improve the price of the company's stock, obtain or maintain essential financing, or comply with debt covenants. This pressure is most likely to affect public companies, but auditors should not underestimate the pressures on nonpublic companies to "stretch" earnings or report a favorable financial condition—particularly in light of the current credit crunch. In most cases, the actions taken are well-intentioned and believed to be appropriate by the company. However, in certain cases, the result is an inappropriate accounting practice.

The downturn in the economy may have an effect on the way a client conducts its business and carries out its revenue recognition policies. Auditors should be alert to facts and circumstances relating to revenue recognition policies that may not be appropriate, such as—

- Changes in standard sales contracts permitting, for example, continuation of cancellation privileges.
- Situations in which the seller has significant continuing involvement or the buyer has not made a sufficient financial commitment to demonstrate an intent or ability to pay.
- Certain sales with a "bill and hold" agreement.

Revenue should not be recorded until it is realized or clearly realizable, the earnings process is complete, and its collection is reasonably assured.

The following are some other accounting practices that distort operating results or financial position:

- Improperly deferring typical period costs and expenses (for example, personnel, training, and moving costs) or costs for which a specific quantifiable future benefit has not been determined
- Adjusting reserves without adequate support
- Nonaccrual of losses (for example, environmental liabilities) or inadequate disclosure in accordance with FASB Statement No. 5, *Accounting for Contingencies*
- Inadequate recognition of uninsured losses (for example, increased deductibles for workers' compensation or medical care)
- Using improper LIFO accounting practices, including inappropriate pools and intercompany transactions

Competent and sufficient audit evidence continues to be the foundation for the auditor's opinion. Insufficient professional skepticism, illustrated by "auditing by conversation," or failing to obtain solid evidence to back up management's representations, can lead to audit problems. In the final analysis, auditors need to step back and ask one of auditing's most fundamental questions: Does it make sense?

Problems also can occur due to errors in recording relatively straightforward transactions, particularly in those situations where cost-reduction and restructuring programs have reduced the number and quality of accounting personnel. The importance of principal audit procedures (for example, sales and inventory cut-off tests, searches for unrecorded liabilities, and follow-up on errors noted during tests) cannot be overemphasized. These types of procedures are fundamental and critical to the audit process.

Although clients may impose fee pressures or tight deadlines on auditors, these pressures do not change the professional responsibility to understand and audit the facts and situations carefully and to make professional, knowledgeable decisions.

Communications Between Predecessor and Successor Auditors

SAS No. 7, *Communications Between Predecessor and Successor Auditors*, establishes requirements for communications between predecessor and successor auditors when a change of auditors has taken place or is in process. It has been observed that the guidance provided by SAS No. 7 is sometimes not followed. It is essential that both predecessor and successor auditors are aware of, and adhere to, the requirements of SAS No. 7. For example, the predecessor auditor should respond promptly and fully to the successor's reasonable inquiries unless he or she indicates that the response is limited.

Part of Audit Performed by Other Independent Auditors

In accordance with SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 543), in no circumstances should an auditor state or imply that an audit report making reference to another auditor is inferior in professional standing to a report without such a reference. When a principal auditor decides not to make reference to the work of another auditor, the extent of additional procedures to be performed by the principal auditor may be affected by the other auditor's quality-control policies and procedures (see auditing interpretation "Part of Audit Performed by Other Auditors: Auditing Interpretations of AU Section 543" [AICPA, *Professional Standards*, vol. 1, AU sec. 9543.18]).

Attorney's Responses

A letter of audit inquiry to the client's lawyer is the auditor's primary means of corroborating information furnished by management concerning litigation, claims, and assessments. Auditors should carefully read all letters from attorneys and ensure that all matters discussed are understood. Ambiguous and incomplete responses should be appropriately resolved with client management and attorneys, and conclusions should be properly documented. An auditing interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, presented in the AICPA's *Professional Standards*, vol. 1, AU sec. 9337.18, discusses what constitutes an acceptable reply. Additional inquiries may be needed if replies are not dated sufficiently close to the date of the audit report.

Pitfalls for Auditors

Each year-end seems to abound with pitfalls for auditors. The following reminders are intended to alert auditors to some of these pitfalls.

- Watch out for large, unusual, one-time transactions, especially at or near year-end, that may be designed to ease short-term profit and cash flow pressures. Scrutinize each transaction to ensure validity of business purpose, timing of revenue or profit recognition, and adequacy of disclosure.
- In performing analytical procedures (for example, analyzing accounts, changes from period to period, and differences from expectations), maintain an attitude of objectivity and professional skepticism. Do not assume that the accounts or client explanations are right. Rather, question, challenge, and compare new information with what is already known about the client and of business in general.
- Make sure that receivables that are supported by real estate as collateral reflect the softening of the market. Increases in the allowance for uncollectibles may be needed. Recognize that assets acquired through foreclosure may be overvalued and difficult to sell.
- Pay special attention to the collectibility of significant receivables from debtors that have recently gone through a leveraged buyout (LBO). A company is not the same entity that it was before an LBO.

Accounting Developments

Financial Instruments Disclosure

In March 1990, the FASB issued Statement No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, effective for fiscal years ending after June 25, 1990. It applies to all entities, including small businesses (due to its requirement to disclose significant concentrations of credit risk arising from all financial instruments, including trade accounts receivable).

The statement applies to all financial instruments with off-balance-sheet risk of accounting loss and all financial instruments with concentrations of credit risk, with some exceptions that are detailed in paragraphs 14 and 15 of the statement. It requires all entities with financial instruments that have off-balance-sheet risk to disclose the face, contract, or underlying principal involved; the nature and terms of the financial instrument; the accounting loss that could occur; and the entity's policy regarding collateral or other security and a description of the collateral.

Postretirement Benefits Other Than Pensions

The FASB is expected to issue the final statement on postretirement benefits other than pensions in December 1990. The proposed statement would significantly change the prevalent current practice of accounting for postretirement benefits on the "pay as you go" (cash) basis by requiring accrual, during the years that employees render services, of the expected cost of providing those benefits to employees and their beneficiaries and covered dependents. This statement would be effective for calendar-year 1993 financial statements. An additional two-year delay would be provided for plans of non-U.S. companies and certain small employers.

In the SEC Staff Accounting Bulletin (SAB) No. 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period,* the SEC staff expressed its belief that disclosure of *impending* accounting changes is necessary to inform readers about expected effects on financial information to be reported in the future and should be made in accordance with existing MD&A requirements. The SEC staff provided supplemental guidance regarding SAB No. 74 in the November 1990 EITF minutes.

Reporting When in Bankruptcy

Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code,* provides guidance for entities that have filed petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11.

The SOP recommends that all such entities report the same way while reorganizing under Chapter 11, with the objective of reflecting their financial evolution. To do that, their financial statements should distinguish transactions and events that are directly associated with the reorganization from the operations of the ongoing business as it evolves.

The SOP generally becomes effective for financial statements of enterprises that have filed petitions under the Bankruptcy Code after December 31, 1990.

Audit Risk Alerts

The Auditing Standards Division is issuing Audit Risk Alerts to advise auditors of current economic, industry, regulatory, and professional developments that they should be aware of as they perform year-end audits. The following industries are covered:

- Airlines (022071)
- Agricultural producers and agricultural cooperatives (022073)
- Banking (022063)
- Casinos (022070)
- Construction contractors (022066)
- Credit unions (022061)
- Employee benefit plans (022055)
- Federal government contractors (022068)
- Finance companies (022060)
- Investment companies (022059)
- Life and health insurance companies (022058)
- Nonprofit organizations, including colleges and universities and voluntary health and welfare organizations (expected to be available in March 1991) (022074)
- Oil and gas producers (022069)
- Property and liability insurance companies (022072)
- Providers of health care services (022067)
- Savings and loan institutions (022076)
- Securities (022062)
- State and local governmental units (022056)

Copies of these industry updates may be purchased from the AICPA Order Department. They will also be included in the new loose-leaf service for audit and accounting guides.

Call toll free: (800) 334-6961 (USA)
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Ethics Division

The AICPA's Ethics Division answers inquiries about the application of the AICPA Code of Professional Conduct. Auditors may call at any of the following numbers:

(212) 575-6217
(212) 575-6299
(212) 575-6736

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